OFFICE OF
THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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CHAIRMAN'S OFFICE
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Signed by:

May 13, 1988

The Honorable John D. Dingell
U.S. House of Representatives
Chairman
Committee on Energy and Commerce
Washington, D.C. 20515

The Honorable Edward J. Markey
U.S. House of Representatives
Committee on Energy and Commerce
Chairman
Subcommittee on Telecommunications
and Finance
Washington, D.C. 20515

Re: Short Selling and Frontrunning
File No. TP 88-274

Dear Chairman Dingell and Chairman Markey:

Thank you for your joint letter, dated March 4, 1988, in which you request further clarification and information regarding short selling and frontrunning addressed in the Division of Market Regulation's ("Division") report, entitled The October 1987 Market Break (February 1988) and addressed in my testimony on the October Market Break before your committee.

Enclosed is a copy of a memorandum prepared by the Division with respect to the questions you have raised. If you have any further questions, please contact me or Richard G. Ketchum, Director, Division of Market Regulation, at (202) 272-3000.

Sincerely yours,

David S. Ruder

David S. Ruder
Chairman

MEMORANDUM PREPARED BY THE DIVISION OF MARKET REGULATION IN RESPONSE TO THE QUESTIONS CONTAINED IN THE LETTER OF MARCH 4, 1988 FROM THE HONORABLE JOHN D. DINGELL AND THE HONORABLE EDWARD J. MARKEY REGARDING SHORT SELLING AND FRONTRUNNING

SHORT SELLING

Question 1: The rationale for the existence of Rule 10a-1 under the Securities Exchange Act of 1934 ("short sale rule"), for each of the exceptions to the short sale rule, and for the letter to counsel for Merrill Lynch, Pierce, Fenner & Smith, Inc. dated December 17, 1986 ("Merrill Lynch letter").

Question 2: Studies and memoranda providing analytical support for the Merrill Lynch letter.

Question 4: Consultation with the Commodity Futures Trading Commission ("CFTC").

Rule 10a-1 ("Rule") under the Securities Exchange Act of 1934 ("Exchange Act") was adopted in 1938 in response to a Commission study of the effects of concentrated short selling in a declining market. The Rule provides, subject to certain exceptions noted below, that short sales of securities covered by the Rule may be effected (1) at a price above the price at which the immediately preceding sale was effected ("plus tick"), or (2) at the last sale price if it was higher than the last different price ("zero-plus tick"). The Rule is designed to limit short selling of a security in a declining market as each successive lower price will have to be established by a long seller. This reduces the ability to employ short selling as a manipulative device to accelerate a decline in the price of a security. At the same time, the Rule allows for relatively unrestricted short selling in an advancing market.

Rule 10a-1 contains a number of exceptions to permit certain types of trading activities that are believed to be beneficial to the markets or that present little risk of the kind of manipulative or destabilizing trading that the Rule was designed to address. Paragraph (e) of the Rule excepts 13 such activities from the "tick test" of paragraphs (a) and (b) of the Rule. Paragraph (a) covers transactions in any security registered on, or admitted to unlisted trading privileges on, a national securities exchange, if trades in such security are reported in the consolidated system. Paragraph (b) covers transactions on a national exchange not covered by paragraph (a). Briefly stated, the exceptions are:

- (e)(1): Exempts a seller who owns the security sold (i.e., is long) and who at the time of sale intends to deliver such security but at the time of settlement must borrow the security for delivery because, for example, the seller's certificates are not received from a foreign location in time. The exception exists so as not to penalize a long seller unable to deliver promptly even though the seller intended to do so at the time of sale.

- (e)(2): Exempts a broker or dealer from unwitting and unintentional violations of the Rule where the broker or dealer, pursuant to a seller's representation, marks an order long when the sale was, in fact, short. The exception protects a broker or dealer from a customer's intentional misrepresentations.

- (e)(3) & (4): Exempts odd-lot dealers because of the immaterial impact of short sales by odd-lot dealers. Permits an odd-lot dealer to sell a round lot short to offset odd-lot orders by customers or to liquidate a long position that is less than a round lot, provided such sale does not change the position of the odd-lot dealer by more than one unit of trading (generally 100 shares). These exceptions are premised on the de minimis nature of odd-lot transactions.

- (e)(5): Subparagraph (i) exempts short sales of a security covered by paragraph (a) by regional exchange specialists and third market makers at prices equal to the last sale in the consolidated system even if that sale is not on a "plus tick" or a "zero-plus tick." Subparagraph (ii) allows specialists and third market makers to honor their quotations that are equal to or above the last sale when communicated. These exceptions are critical to permit secondary market specialists to ensure that orders routed to their markets receive execution at least equal to the primary market price.

- (e)(6): Exempts transactions in a security covered by paragraph (b) that equalize the price of a security on a regional exchange with its price in the principal exchange market for the security. The exception is available provided that the transaction is necessary to bring about an equalization in price and the transaction has been approved by the exchange upon which it is executed.

- (e)(7): Exempts short sales effected in bona fide domestic arbitrage transactions involving convertible, exchangeable and other rights to acquire the securities sold short, where such rights of acquisition were originally attached to or represented by another security or were issued to all the holders of any class of securities of the issuer. This exception does not extend to index arbitrage.

- (e)(8): Exempts domestic short sales made as part of international arbitrage transactions (i.e., transactions in which a position taken in a security in a domestic securities market is to be immediately offset by a position taken in that security in a foreign securities market) if the bona fide purpose is to profit from the price difference between the foreign exchange and the domestic exchange. This exception does not extend to index arbitrage.

- (e)(9): Permits the orderly distribution of substantial blocks of listed securities provided the sales are effected in accordance with certain special offering plans filed by an exchange and approved by the Commission.

- (e)(10): Exempts short sales by an underwriter in connection with the overallotment of securities in a distribution and lay-off sales in connection with a rights offering pursuant to Rule 10b-8 under the Exchange Act or a standby underwriting commitment.

- (e)(11): Permits a broker or dealer, under certain specified circumstances, to effect short sales of a security at a price equal to the broker or dealer's most recently communicated offer for that security. This exemption means that pre-existing offers to sell are exempt if the offer, when communicated to a quotation system, did not violate the "tick test."

- (e)(12): Expands the definition of the term "third market maker" and makes a broker's short sales of a reported security eligible for Rule 10a-1's exemptions with respect to transactions by third market makers only if the broker communicates quotations for that security in accordance with the quote rule.

- (e)(13): Permits a block positioner who is selling a security acquired while acting in that capacity to disregard, in determining whether it is long or short, a proprietary short position in that security to the extent such short position is the subject of one or more offsetting positions, created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

In the Merrill Lynch letter, the Division of Market Regulation ("Division") staff took a limited no-action position under Rule 10a-1 for certain liquidations of index arbitrage positions. Specifically, the Division permitted the "unwinding" of existing index arbitrage positions involving long baskets of stock and short index futures or options without aggregating short positions in these stocks with other proprietary accounts if those short positions were fully hedged. The Division took this position because the unwinding of an existing long arbitrage position did not create a new short position, nor should any price decline resulting from the selling benefit the firm because the requirement that the firm's remaining positions are "fully hedged" (i.e., are economically neutral) ensures that any "gain" in the short

stock position will be offset by a matching "loss" in the long position for that security. There is no incentive to engage in manipulative short selling to drive the stock price down in this instance, and adherence to the Rule's "tick test" would not serve to prevent the manipulative trading that the Rule addresses. It should be noted that the letter does not extend to the creation of index arbitrage positions involving the short selling of stock and the purchasing of index options or index futures.

The rationale for the Merrill Lynch letter is closely analogous to that underlying exception (13) to Rule 10a-1, and the letter is modeled after that exception. Enclosed is a copy of Securities Exchange Act Release No. 20230 (September 27, 1983) (proposing exception (13)) and Securities Exchange Act Release No. 20715 (March 6, 1984) (adopting exception (13)). More generally, the staff considered the following materials: Board of Governors of the Federal Reserve System, CFTC and SEC, A Study of the Effect on the Economy of Trading in Futures and Options (December 1984); SEC, Roundtable on Index Arbitrage, Background Materials (July 9, 1986); and information gathered in preparing the Division's Report on the Role of Index-Related Trading in the Market Decline on September 11 and 12, 1986 (March 1987). Copies of these items are available from the Division.

The Merrill Lynch letter was not discussed with the CFTC prior to issuance. The CFTC does not administer an analogous

rule. The Merrill Lynch letter dealt only with sales of securities in markets regulated by this Commission.

Question 3: Enforcement actions under 10a-1 and description of surveillance procedures to enforce short sale regulation.

Consistent with the self-regulatory structure of the Exchange Act, the various securities exchanges and the National Association of Securities Dealers have the primary responsibility for surveilling and enforcing short sale regulations. The securities exchanges incorporate reviews of short sale activities as part of surveillance inquiries and investigations of unusual price declines both in individual securities and their markets as a whole. While these short sale reviews ordinarily rely upon audit trail data, if there are questions concerning whether short sales were properly reported by broker-dealers, the exchanges' examination staffs will reconstruct account and trading records. Since 1985 there have been 15 securities exchange disciplinary actions involving short sale activity. A copy of each final disciplinary action is enclosed. The disciplinary actions fall into two groups: those involving marking violations (*i.e.*, marking sell orders "long," when in fact such sales were "short") and those involving tick test violations (*i.e.*, selling short on a "minus" tick or a "zero-minus tick").

The Commission does, however, currently have short sale enforcement inquiries in progress. These investigations

principally relate to trading in connection with the October Market Break.

<u>Question 5</u>: The effect of the Merrill Lynch letter on market pricing efficiency and the extent of additional index arbitrage effected as a result of the Merrill Lynch letter.

<u>Question 6</u>: The Commission's ability to track compliance with the Merrill Lynch letter.

As the Commission stated in its testimony on the October Market Break, the Commission believes that index arbitrage generally provides important benefits to the interrelated stock and derivative markets. The offsetting purchases and sales (or sales and purchases) of stocks and derivative securities tend to bring prices in those markets closer into line by raising values in the market that is relatively under-priced and reducing values in the market that is relatively over-priced.

The Merrill Lynch letter has the effect of reducing the cost of liquidating index arbitrage positions. The element of cost reduced is the price risk involved in waiting for an uptick in the price of a particular security to be sold, or the cost of hedging to avoid that risk. By reducing the costs of arbitrage transactions, the letter facilitates the pricing efficiency that index arbitrage promotes. The aggregate cost avoided by the relief granted in the Merrill Lynch letter would generally be very small, however, since fully hedged positions would typically exist in other accounts in only a small portion of the stocks involved in an index arbitrage "basket."

The Commission does not have the information available to quantify the extent of index arbitrage activity facilitated by the Merrill Lynch letter. In response to a staff questionnaire as part of the Division's report entitled The October 1987 Market Break (February 1988) ("Report"), of 13 broker-dealer firms surveyed, only one firm was able to quantify its reliance on the Merrill Lynch letter in unwinding index arbitrage transactions in October 1987. Several firms advised the staff that they did not rely on the Merrill Lynch letter during the October Market Break. See footnote 68 on page 3-26 of the Report. The Merrill Lynch letter does not to any significant degree alter the way that index arbitrage is conducted; therefore the amount of any incremental arbitrage activity due to the Merrill Lynch letter is probably nominal.

As is the case with virtually all situations where the Commission or its staff determines that relief from certain provisions of the securities laws is appropriate, the grant of relief is conditioned upon conduct consistent with the representations made by the requestor in seeking such relief. Conduct that varies in any material respect from those representations is outside the scope of the relief. See Beaumont v. American Can Co., 797 F.2d 79, 83 (2d Cir. 1986). Accordingly, the Division would expect that the New York Stock Exchange's ("NYSE") periodic examination of member firms would include any activity occurring based on the interpretive position as part of its review of the member firm's compliance

with Rule 10a-1. Absent the receipt of information to the contrary, the staff assumes that the recipient of such relief acts in accordance with its representations. Where, however, the staff becomes aware of conduct inconsistent with the terms of relief that has been granted (through inspections, complaints, etc.), it may determine to commence an inquiry or investigation to determine whether violations of the law have occurred.

Question 7: The meaning of the terms "bona fide arbitrage," "risk arbitrage," and "bona fide hedging" and the distinction between "bona fide hedging" in relation to other types of hedging.

The Merrill Lynch letter specifies that, for purposes of the letter, the terms bona fide arbitrage, risk arbitrage, and bona fide hedging have the meanings ascribed to these terms in Securities Exchange Act Release No. 15533 (January 29, 1979) ("Release") (attached). In that Release, bona fide arbitrage is defined as "an activity undertaken by market professionals in which essentially contemporaneous purchases and sales are effected in order to 'lock in' a gross profit or spread resulting from a current differential in pricing." Risk arbitrage is defined as a transaction effected with a view to profit from the consummation of a merger, acquisition, tender offer or other similar transaction involving a recapitalization. The Release states that the concept of a bona fide hedge is largely a matter of custom and practice but must involve long and short positions in related securities where one security is exercisable, convertible, or otherwise related by

its terms to the other security, and substantially offsets the risk of that security. Hedges that do not offset most or all of the risk, or are not composed of such securities, would not be bona fide for purposes of the Merrill Lynch letter.

Question 8: Should the short sale rule provide an exception for index arbitrage, and the effect during the October Market Break if such an exception had been in existence.

Question 9: Recommended changes in the short sale rule and associated interpretations.

As stated in the response to Question 5, the Commission believes that index arbitrage is generally beneficial to the equity and futures markets. The short sale rule has exceptions for other forms of arbitrage (see response to Question 1) because they are beneficial and do not involve a manipulative potential. The Division is aware, however, of the need to balance the market efficiency benefits of index arbitrage unimpeded by the short sale rule with the fact that the short sale rule prevents some incremental selling from occurring in declining markets. The Division also understands that Rule 10a-1 has substantial public support and thereby may contribute to public confidence in the markets.

The Division's Report at page 3-26 states that it is not possible to conclude whether the absence of restrictions on short index arbitrage would have lessened the market decline by eliminating or reducing the discount in the index futures prices on October 19 or instead would have exacerbated the decline by the direct effects of additional selling.

The Division is undertaking an analysis of the appropriate role of short sale regulation and the effectiveness of the current rule in view of active derivative markets and increasing internationalization. The Division hopes to complete that analysis and submit it to the Commission for consideration sometime this Summer. Thus, the Division is not yet in a position to comment on possible changes in short sale regulation.

II. FRONTRUNNING

Question 1: Enforcement actions taken to date regarding frontrunning.

Question 2(a): Current federal or SRO regulations or rules which prohibit frontrunning in stocks, futures and options.

Question 5: Does the Commission view frontrunning as a form of insider trading? Should it be covered in any statutory definitions which are currently being considered?

Question 7: Explain how the regulation of frontrunning differs between the securities and options and the futures markets.

Frontrunning may be generally defined as involving trading a stock, option, or future while in possession of non-public information regarding an imminent block transaction that is likely to affect the price of the stock, option, or future. The Commission, since the development of standardized individual equity options, has viewed frontrunning as a serious trading abuse that can adversely affect the integrity of the markets.

Certain instances of frontrunning may be analyzed pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 as a form of insider trading. For example, instances of a broker-dealer trading in derivative markets to take advantage of the market impact of a customer's stock order might be addressed as a form of misappropriation of material non-public market information in breach of a fiduciary obligation of trust and confidence, although we are not aware of any case that has done so. 1/

The Commission has preferred to address this issue by working with the securities self-regulatory organizations ("SROs") to detect and prosecute frontrunning activities in these markets as violations of the rules of these SROs. Although none of the exchanges has a specific rule proscribing frontrunning, each exchange has issued circulars that prohibit frontrunning as conduct inconsistent with just and equitable principles of trade. Following the introduction of stock index option contracts, these circulars were amended to include index option trades based on material non-public information concerning transactions in any of the component securities of the index likely to affect its price ("index options front-running"). 2/ Copies of the most recent frontrunning circulars

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1/ *See generally* *United States v. Carpenter*, 108 S. Ct. 316 (1987); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

2/ On April 13, 1988, the NYSE issued an Information Memo to Members and Member Organizations, No. 88-9, that, when approved by the Board of Governors of the NYSE, would

are attached. Recently these frontrunning circulars were filed with the Commission as rule changes which became effective upon filing pursuant to Section 19(b)(3)(A) of the Exchange Act.

Because frontrunning abuses have been addressed as SRO rule violations, prosecution of frontrunning violations has been primarily the responsibility of the SROs'. Commission staff, however, routinely evaluate the effectiveness of SRO programs to detect and prosecute frontrunning violations as part of our oversight responsibilities under Section 19(h) of the Exchange Act. In addition, copies of final SRO disciplinary actions, including frontrunning violations, are filed with the Commission pursuant to Section 19(d)(1) of the Exchange Act. 3/ The Division believes that present SRO prosecution of frontrunning activity has been effective in minimizing this type of trading abuse in the options and equities markets and that legislative amendments to incorporate frontrunning within proposed statutory definitions of insider trading are not necessary to deter these abuses in these markets.

We are unable to reach a conclusion as to whether frontrunning in the futures markets is subject to the same

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prohibit NYSE members from trading stock index futures while in possession of material non-public information concerning transactions in any of the component securities of the index likely to affect its price ("index futures frontrunning").

3/ Copies of all final exchange disciplinary actions (from 1984 to date) involving frontrunning violations are attached in response to your request to identify all frontrunning enforcement actions.

regulatory scheme that exists in the securities markets. While Chicago Mercantile Exchange ("CME") and Chicago Board of Trade ("CBT") officials both have indicated that their rules prohibit frontrunning of customer orders within the futures market 4/, they have issued no policies or interpretative positions which explicitly state that the rules of the CME or CBT prohibit a CBT or CME member firm from trading stock index futures for its own account before executing blocks or baskets of securities. 5/ As indicated above, the NYSE recently issued a circular to members indicating that NYSE rules prohibit such conduct. 6/

Question 2(b): The Commission's views as to how prohibitions against frontrunning should be made express, strengthened and more effectively enforced.

Question 4: Surveillance methods used to detect frontrunning including a description of joint surveillance efforts existing between the SEC and CFTC.

As described in the previous answers, primary surveillance and discipline functions for frontrunning violations are

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4/ See Division of Economic Analysis & Division of Trading and Markets, Final Report on Stock Index Futures and Cash Market Activity during October 1987 to the U.S. Commodity Futures Trading Commission (January 1988), at 199.

5/ See Board of Governors of the Federal Reserve System, CFTC, and SEC, A Study of the Effects on the Economy of Trading in Futures and Options (December 1984), at VII-40 to VII-41.

6/ See note 2 supra. While traditionally the options exchanges have had the primary responsibility to address members' stock/options frontrunning abuses, pursuant to the practice of the Intermarket Surveillance Group, the stock exchanges have the authority to address trading abuses by their member firms.

performed by the securities exchanges. In general, these exchanges rely upon surveillance systems based on accurate audit trail transaction information to detect potential frontrunning violations, 7/ and, equally important, where the trading occurs in different markets, sharing of surveillance information and coordination of investigations. Under the Commission's auspices, audit trail systems have been implemented on all major securities markets. 8/ In 1981, the securities SROs formed the Intermarket Surveillance Group ("ISG") to coordinate more effectively surveillance and investigative information sharing arrangements for such "intermarket" trading abuses such as stock-options

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7/ An "audit trail" is a time-sequenced compilation of trading activity, including certain characteristics of the trade (i.e., price, quantity, time, identification of clearing firms and executing brokers and principal/ agency designators), obtained from trade tickets submitted by the executing parties.

8/ Exchange frontrunning circulars generally provide that a violation may be based upon knowledge of less than all of the terms of the transaction if there is knowledge that all of the material terms of the transaction have been or will be imminently agreed upon. Typically, exchange surveillance systems generate alerts when options trading occurs within a fixed period of time before or after a block-sized trade in the underlying security is reported. Often, however, the size of an order will be sufficiently large to have a near certain impact upon the markets. In these instances frontrunning opportunities may arise from knowledge of the order without knowing the material terms of the trade. The potential for such frontrunning abuses was evident in October where large portfolio insurance trading programs were triggered following the large market moves on the 16th and 19th.

frontrunning. 9/ In addition, Commission staff routinely evaluate the effectiveness of these SRO programs and have found that these measures, coupled with a vigorous enforcement effort, have been effective for minimizing this type of trading abuse in the options and equities markets.

It has become evident over the last few years that opportunities now exist for similar trading abuses involving the index futures and securities markets. In fact, because the price movements in the index futures markets at times can significantly influence stock prices (unlike index options, which generally react to stock price movements rather than influence stock prices), opportunities exist not only to use index futures to frontrun blocks of stock transactions, but to use stock transactions to frontrun significant index futures transactions. The Division believes that the securities and futures SROs, under the supervision of the SEC and CFTC, need to accelerate current efforts to address these frontrunning abuses by: (1) clarifying the status of intermarket frontrunning as violative conduct under either the Commodity Exchange Act or the rules of the stock index futures contract markets; (2) developing routine intermarket access to this surveillance information and routine automated programs to "flag" suspicious transactions; (3) developing procedures to coordinate

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9/ Effective October 1, 1986, the CFTC also required all futures exchanges to have in place systems designed to capture trade data for all transactions effected on their floors within one minute of execution.

frontrunning investigations involving stock index futures and securities; and (4) prosecuting violations which are identified. 10/

Question 3: The nature and magnitude of possible frontrunning identified during the October Market Break.

Question 8(a): Does the SEC plan to examine proprietary trades carried through another CME member clearing firm in order to determine if frontrunning occurred? Identification of all proprietary stock index futures trades by investment firms.

Question 8(b): Explain how "using a one minute time frame may artificially narrow the scope of the identified activity."

As part of the review of trading during the October Market Break, the Division reviewed surveillance data supplied to the Commission by the CME. The review was conducted to determine whether CME member firms, known to be active portfolio insurance vendors or executing brokers, were frontrunning customer orders implementing portfolio insurance strategies. The staff reviewed whether these firms were trading stock index futures for their proprietary accounts during certain periods when portfolio insurance trading in the futures and securities markets was the greatest (i.e., the last hour of trading on October 16 and the first hours of trading

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10/ Futures exchanges and CFTC representatives participated in the most recent quarterly ISG meeting. One of the items on the agenda concerned granting permanent membership status to the futures exchanges. In addition, the ISG and the futures exchanges have formed a working subgroup on intermarket securities and futures regulation to discuss these intermarket trading abuses and the development of procedures to share surveillance and investigative information. The Subgroup met on April 21 and 22 at the NYSE and is scheduled to reconvene on May 16 in Chicago.

on October 19 and 20). As indicated in the study, only a few instances appeared to warrant further inquiry. Most of the trades reported for CME member firm proprietary accounts did not support the conclusion that portfolio insurance vendors or brokers were frontrunning customer orders. During this period, sixteen trades from member firm proprietary accounts raised possible frontrunning concerns, but only three of these trades involved proprietary transactions of ten or more contracts. Moreover, there could be legitimate reasons to account for these proprietary transactions that also required further explanation before concluding that frontrunning violations had in fact occurred. Because these trades were executed solely in the futures markets, referral to the CFTC was made for whatever further investigation was deemed to be appropriate. As a result, the Division presently has no plans to examine such possible proprietary trades carried through a CME member clearing firm.

Other "frontrunning" opportunities may have existed on October 19 and 20 because the futures markets opened for trading more quickly than the stock markets on those days. As a result, firms in possession of non-public information concerning large orders to purchase or sell stock at the opening on October 19 and 20 would have been able to use this information to trade index futures contracts before the stock market opened for trading. For this reason, the Division expanded the scope of its frontrunning review by comparing

proprietary index futures trading activity at the opening on October 19 and 20 with firms executing significant customer stock programs. The Division's analysis was limited to 13 investment firms. These firms, however, included the majority of those firms known to be active portfolio insurance vendors or brokers. Although our analysis could not be conclusive without further investigation, these proprietary trades, as indicated in the market study, may have disadvantaged customer orders in the derivative markets and contributed to price volatility by increasing the discounts in these markets at the opening on October 19 and increasing the premiums in these markets on October 20. The results of this review also were furnished to the CFTC.

Question 8(d): Should the CME audit trail include the identity of the clearing member and executing broker and, in addition, the identity of the end customer?

It is our understanding that neither the securities, options or futures audit trail systems contain the identity of customers. Such a requirement, in either market, would be difficult to implement and administer without impeding the efficacy of present day floor trading. Rather, present audit trail systems identify exchange member clearing firms from which securities SROs are later able to obtain the identity of customers engaged in trading activity. Futures audit trail systems do identify customer account numbers, but it is our understanding that futures SROs are not able to identify

directly the beneficial owner(s) of the account solely from audit trail information.

Question 8(b): Surveillance of possible frontrunning activity and the jurisdictional relationship between the SEC and the CFTC over the stock index futures market.

Question 8(e): SEC access to futures trading information. Ideally, what access does the SEC need to such information in order to detect frontrunning abuses?

Routine surveillance for frontrunning violations, whether in the stock, options or futures markets, requires accurate transactional audit trail information. In addition, the Division's Report, at page 3-27, recommended consideration of improved reporting systems for program trading and possible development of large-trader reporting systems for the stock market. The information from these systems would enhance surveillance for frontrunning. In this regard, effective May 2, 1988, the NYSE required member firms to report routinely to market surveillance all program trades for proprietary and customer accounts. While all of these markets have operating audit trail systems, operating mechanisms for the sharing of this surveillance information presently only exist between the stock and options markets. Implementation of informational sharing mechanisms between the securities and futures markets is essential for effective detection and ultimate prosecution of frontrunning violations involving stock and stock index futures. As discussed above, the Commission is placing high priority on working with the CFTC and the stock, options and

futures SROs to develop and implement effective procedures to share surveillance data and coordinate investigations and disciplinary actions involving frontrunning violations between the futures and stock and options markets.